

An analysis of the tax implications for an employer and employee of a deferred compensation scheme.

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compensation scheme.

Being a technical report submitted by

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ABSTRACT

The aim of this report is to analyse the tax implications for an employer and an employee of a deferred compensation scheme from the inception of the scheme, at retrenchment, disability, on death or retirement. the report examines the levying of normal tax (income tax), donations tax and estate duty.

DECLARATION

I hereby declare that this report is entirely my own work.

ACKNOWLEDGEMENT

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Deferred Compensation Schemes

Chapter 1

Introduction

What is a deferred compensation scheme?

A deferred compensation scheme is a benefit offered by employers to selected employees in order to promote a settled and contented staff and to induce the employer's employees to remain in the employer's employ for as long as possible. It defers a portion of the employee's remuneration until he retires, when it is paid out as a lump sum. It is constituted by an agreement between the employer and the employee, in terms of which the employer undertakes to pay the employee a sum of money at retirement or on the occurrence of some other specified event. The vehicle to fund the benefit normally consists of an assurance policy, which the employer undertakes to effect on the life of the employee.

Why a deferred compensation scheme?

Senior employees are usually in the upper income bracket and as a result they forfeit a large portion of their earnings in taxes. Once the maximum tax bracket is reached, an increase no longer seems as attractive as 45% of every rand of the increase is paid in normal tax. Employees are looking for tax-effective packages from their employers in order to enjoy the maximum amount possible from their earnings.

These same employees have also often gained their expertise in the occupation in which they work by working during their working careers for a number of different employers in order to gain different skills from each. This usually means that their pension benefits has been eroded as they have moved from one employer to the next and the provision which they have with their final employer may be insufficient. Additional provision needs to be made to ensure that their earnings or that of their dependants does not drop substantially on retirement or death. It is often difficult for the employee to make additional provisions on his own because of the high tax bracket in which he finds himself.

Employers are finding that they are increasingly pressured into providing additional retirement provisions to key employees over and above the standard pension or provident fund benefits which are offered to all employees, in order to attract skilled staff and to keep them from being attracted to competitors.

A deferred compensation scheme is an excellent means for an employer to reward key employees and for an employee to make additional retirement provision. It has the added benefit of being a tax-efficient investment for both parties.

A deferred compensation scheme will consist of the following elements:

- The employer and employee will enter into a service agreement whereby the employer undertakes to pay a lump sum to the employee under any of the following circumstances:
 - if the employee resigns or withdraws from the employer before retirement; or
 - when the employee reaches retirement; or
 - if the employee dies before reaching retirement, in which case the lump sum will go to the employee's estate or dependants.
- The lump-sum payment is funded by a policy on the life of the employee and which is owned by the employer. An endowment policy is normally used.
- The premiums paid on the policy are paid for by the employer and are generally tax deductible in the employer's hands.
- On the selected date, the policy matures and the employer receives the proceeds. The employer then pays over the proceeds to the employee in terms of the provisions of the service agreement.
- On receipt of this award, the employee may enjoy certain tax concessions

Chapter 2

The Service Agreement

The service agreement (see Annexure A) will cover the following details:

- The normal retirement age of the employee for the purposes of the deferred compensation scheme.
- The employee's rights to the proceeds of the policy, in the event of premature retirement due to ill health or other disability.
- The rights of the employee's family and dependants should he die prior to normal retirement age.
- The employer's discretionary powers in respect of the policy should the employee resign before normal retirement age.
- The nature of the retirement benefit:
 - a pension for life; or
 - a cash lump sum; or
 - a combination of a pension and a cash lump sum; or
 - an outright cession of the policy

- The provisions to be applied if the employee's services are terminated due to ill health or permanent disablement.
- The provisions to be applied if the employee's services are terminated as a result of the employer's liquidation or merger with another employer or if the employee is retrenched.

The service agreement plays an important role in the deferred compensation scheme because it will determine whether the lump sum awarded to the employee by the employer will be regarded as a voluntary award or not by the Commissioner for the SARS for income tax purposes.

It is important in the drafting of the agreement that no vested rights are given to the employee and that he does not receive an unconditional entitlement to the benefits in any circumstances as this implies that the payment is for past services and not as an incentive to remain employed by that employer.

It must be solely in the discretion of the employer whether to cede the policy to the employee on resignation or dismissal or to pay the proceeds to the employee. If this does not occur then the premiums paid by the employer will be subject to the provisions of section 7(1) of the Income Tax Act (the Act).

Section 7(1) of the Act is an anti-avoidance provision and reads as follows:

‘Income shall be deemed to have accrued to a person notwithstanding that such income has been invested, accumulated or otherwise capitalized by him or that such income has not actually been paid over to him but remains due and payable to him or has been credited in account or reinvested or accumulated or capitalized or otherwise dealt with in his name or on his behalf, and a complete statement of all such income shall be included by any person in the returns rendered by him under this Act.’

If the Commissioner is of the opinion that the employer is merely paying the premiums on the policy as payment for services rendered in order for the employee to avoid paying the premiums with earnings on which normal tax has already been levied, then section 7(1) will be invoked with the result that the employee will be required to include in his gross income the amount of the premiums paid and the tax benefit to the employee will be lost.

Chapter 3

Who will Qualify for Deferred Compensation.

An employer-employee relationship is a necessary requirement for a successful deferred compensation scheme.

It is necessary to look at the structure of the different types of business entities in order to determine whether an employer-employee relationship exists and a deferred compensation scheme could be implemented.

Sole Proprietorship

A sole proprietor trades for his own account. The entity does not have a legal identity separate from its owner. The sole proprietor cannot be both employer and employee and is therefore not able to effect a deferred compensation scheme on his own life for his own benefit. If he employs staff in his business, he could, however, effect a deferred compensation scheme for his employees.

Partnerships

A partnership is a contractual relationship between two or more people in terms of which they agree to pool their money or skills in order to make a profit. The partners do not

have a legal identity separate to that of the partnership and therefore there is no employer-employee relationship between the partnership and the partners. The partners would not be able to effect deferred compensation schemes on their own lives but, as with the sole proprietor, they could effect a deferred compensation scheme for their employees.

Companies

A company has a legal identity separate from that of its shareholders. An employer-employee relationship can therefore exist between the company and its shareholders if they are employed as directors and also directors who are not shareholders. A deferred compensation scheme can therefore be implemented for directors and for shareholders provided that they are actually employed by the company.

A problem may, however, arise in the case of a 'one-man' company, that is, a company with a sole shareholder or even a company where a director holds 75% of the shares and is the beneficiary of a deferred compensation scheme. The company may find it difficult to persuade the Commissioner that the deferred compensation was necessary to induce the director to remain with the company until retirement age and the payment of the lump sum on retirement was 'for the purposes of trade'. If he is the sole or majority shareholder it is unlikely that he requires an inducement to remain with the company.

In the Special Income Tax Court in *ITC 1506*¹ this issue was addressed. The facts were as follows:²

‘In 1984 the appellant, a close corporation, carrying on business as a used car dealer, paid an amount of R16 998 to a retiring employee, B, who was also the majority interest holder.

‘In 1980 the appellant, on the advice of its accountant, took out a three year endowment policy, the proceeds to be paid to appellant. At about the same time appellant passed a resolution in terms of which, *inter alia*, selected employees would receive gratuities on retirement. An agreement was then entered into with B for the payment to B, in effect, of the proceeds of the endowment policy. According to the preamble to the agreement the payment was made to retain B’s services, until he attained the age of 60.

‘Appellant sought to deduct the amount of R16 998 in terms of section 11(a) read with section 23(g) of the Income Tax Act 58 of 1962. The deduction was disallowed, objection to the disallowance was rejected and the appellant appealed to the Special Court.’

The Special Court, after examining the facts, found for the Commissioner, holding as follows:³

‘It held that the payment was not in the production of income as required by section 11(a) because it was abundantly clear that even if the agreement in terms of which the appellant agreed to pay the gratuity to B on his retirement had not been concluded, B would have remained with the appellant at least until the age of 60. (B in fact said in evidence that the payment was never to

¹ 1953 SATC 418

² RJ Millar and W. Irwin, *Tax Advantages of Life Assurance*, MDR Publications, Issue 11/98 at C25.

³ RJ Millar and W. Irwin, *Tax Advantages of Life Assurance*, MDR Publications, Issue 11/98 at C25.

improve the income of the appellant, but was rather designed towards providing him with a retirement benefit which he would otherwise not have had.)

‘It was held alternatively that the payment was not an expense exclusively laid out or expended for the purposes of trade and therefore would not be allowable because of the provisions of section 23(g), which at the time required that an expense be “wholly or exclusively laid out or expended for the purposes of trade” before it is deductible. Section 23(g) was amended, with effect from the commencement of years of assessment ending on or after 1 January 1993, to allow for an apportionment of the expense.’

The following statement from the *Momentum Life Easiguide* is relevant in this regard.⁴

‘This accentuates an important principle, upheld in previous tax cases on point, that these plans should not be used to reward past services. Instead there must be a genuine incentive, without which the rendering of additional future services or quality in future performance is less likely to occur. It is difficult (although not impossible) to create genuine incentives towards added performance for “de facto” proprietors of CCs and small companies, considering that share-ownership is perhaps the strongest motivator of successful performance in the first place.’

Close Corporations

The legal identity of a close corporation is separate from that of its members and therefore, provided that the member is actually employed by the close corporation, the members and employees can be part of a deferred compensation scheme.

⁴MA Kourie and J Oosthuizen, *Momentum Life Tax and Investments Easiguide*, Butterworths 1996 at 389.

Chapter 4

Funding the Deferred Compensation Scheme

The premiums for a deferred compensation policy may be funded in one of three ways:

- The employer may fund the premium as a 'perk' to the employee in addition to the employee's usual remuneration in order to promote a settled workforce or to persuade a particular employee to remain in the employ of the employer.
- The employee may reduce his existing remuneration package and use the amount by which it is reduced to fund the premiums. This will result in a reduction in the normal tax which is payable on his earnings and allows the premiums for his 'retirement fund' to be paid with earnings on which normal tax has not yet been levied.

Where an employee opts to reduce his remuneration package and fund the premiums by way of a salary sacrifice then:⁵

'the employer runs the risk that the eventual section 11(a) deduction will be disallowed. This is because the employee invariably obtains a vested right to the benefits upon early withdrawal from the scheme. The result is that the arrangement may be seen as no more than reimbursement for past services, rather than an incentive to remain in the employer's service.'

⁵MA Kourie and J Oosthuizen, *Momentum Life Tax and Investments Easiguide*, Butterworths 1996 at 389.

- The employee foregoes a salary increase or bonus and this amount is then used by the employer to fund the premiums.

A high-taxpaying employee would not gain much benefit from a salary increase due to the high income tax bracket in which he finds himself. The employee may decide to forego an increase in salary and arrange for the employer to take out an endowment policy on his life. The employer and the employee will then enter into a service agreement, in terms of which the company agree to pay the proceeds of the policy to the employee at retirement or to his heirs should he pass away prior to retirement. Due to the premium on the policy being paid with earnings on which normal tax has not yet been levied and the tax advantages of section 10(1)(x) and section 7A(4A) the benefits received using a deferred compensation scheme are far greater than taking an increase in salary.

Chapter 5

Tax Implications For The Employer

The policy will be taken out by the employer on the life of the employee. It is therefore owned by the employer and is known as 'an employer owned policy'. There are tax implications for the employer in respect of both the premiums paid by the employer during the term of the policy and the proceeds of the policy paid to the employer on maturity of the policy prior to it being paid across to the employee in terms of the service agreement.

At inception of the scheme

Legislation was introduced in June 1982 affecting the deductibility of premiums. As a result of this, policies taken out prior to 1 June 1982 and policies taken out after 1 June 1982 may receive different tax treatment as regards the deductibility of premiums. The Act makes provision for three types of policies, the premiums of which, rank for deduction in terms of section 11(w).

Policies effected before 1 June 1982

Premiums payable by an employer on a policy on the life of an employee are deductible from the taxable income of the employer. This deduction is allowed in terms of section 11(w) of the Income Tax Act.

Section 11(w)(dd) provides as follows:

‘No allowance shall be made under this paragraph in respect of any premium paid under any insurance policy unless –

‘(A) such policy was effected in terms of a written proposal accepted by the insurer before the 1 June 1982 or the proposal for such policy was made before 25 May 1982 and accepted by the insurer not later than 21 June 1982.’

Section 11(w)(ee) further provides the following:

‘The allowance under this paragraph in respect of premiums paid by the taxpayer during the year of assessment shall, except as provided in subparagraph (iii), be limited –

‘(A) in the case of premiums paid under a policy referred to in subparagraph (A) of paragraph (dd) of this proviso, to so much of such premiums as were payable in terms of the conditions contained in that policy on 31 May 1982.’

If an increase to premiums was not part of the contract as at 31 May 1982, for example, voluntary increases by the taxpayer, then these increases will not be allowed as a deduction in terms of section 11(w).

Premiums will not be deductible in terms of section 11(w) if any of the following occur:

- The policy was not the property of the employer at the time of payment of the premium. An employer can therefore not claim a deduction in terms of section 11(w) for premiums which it pays on a policy belonging to the employee.
- Any person other than the employer was entitled, or would have been entitled to any benefits that were or could have become payable under the said policy (for example, a beneficiary nomination on the policy).
- Any loan or advance was made to any person on the security or strength of the policy other than a loan or advance referred to in paragraph (m) of the definition of 'gross income' in section 1 and any amount was owing during the year of assessment in respect of the loan or advance or in respect of interest or other charges relating thereto, unless the Commissioner is satisfied that the loan or advance was arranged in order to obtain funds required by the employer for purposes of trade in consequence of the employee's or director's ill-health, infirmity, incapacity, retirement or cessation of services occurring after the policy was acquired by the company.
- A claim is made under any of the sections of the Act other than section 11(w) except in certain cases where it may be appropriate to make a deduction under section 11(a) or (b).

The employer is entitled to deduct in full the annual premiums that it actually pays during the year of assessment in terms of section 11(w)(i) which reads as follows:

‘An allowance in respect of any premium which was actually paid by the taxpayer under any policy of insurance taken out upon the life of an employee of the taxpayer or, in the case of a company, upon the life of a director or an employee of that company, the amount of such allowance to be as follows:

- ‘(i) where the life of the employee or director is insured for a period of not more than one year or where the only premiums payable under the said policy are premiums of equal amount payable at regular intervals of not more than one year until benefits (other than interim or temporary benefits) become payable or commence to become payable under that policy, an amount equal to the amount of the premium which became payable under such policy during the year of assessment.’

Section 11(w)(ii) then reads as follows:

- ‘(ii) in any other case, an amount equal to such portion of the premium paid under the said policy as, in the opinion of the Commissioner (having regard inter alia to the terms of the policy and, in the appropriate circumstances, to the expectation of life of the employee or director) should be regarded as relating to the year of assessment.’

Section 11(w)(ii) provides that single premiums are spread for deduction purposes proportionately over the years of assessment falling during the period of the policy in the case of an endowment policy or in the case of a whole life policy over the expected life expectancy of the life assured.

'Term' Policies

Section 11(w)(dd) provides as follows:

‘No allowance shall be made under this paragraph in respect of any premium paid under any insurance policy unless –

‘(B) the only benefit payable under the policy is a benefit payable within a period fixed in such policy upon or by reason of the death or disablement of the employee or director whose life is insured under the policy or the policy is a personal accident policy as defined in section 1 of the Insurance Act, 1943 (Act No. 27 of 1943).’

A term policy only provides benefits on the death or disability of the insured and covers this risk for a specified period. A term policy carries no surrender, loan or paid-up values. The amount of premium that is deductible is not limited by section 11(w). A term policy includes ‘personal accident policies’, which only pay out in the event of an accident or sickness causing death, injury or disability.

Policies effected after 1 June 1982

The third category is also set out in section 11(w)(*dd*) and reads as follows:

‘No allowance shall be made under this paragraph in respect of any premium paid under any insurance policy unless:

‘(C) The Minister of Finance has by regulation prescribed requirements in regard to terms and conditions with which insurance policies shall conform for the purposes of this subparagraph and the policy conforms with such requirements.’

The deductibility of premiums in respect of this category of policy is restricted to an amount equal to 10% of the remuneration of the employee. Remuneration has the same meaning as it is given in the Fourth Schedule of the Act in that it includes:

- Salary,
- leave pay,
- wages,
- overtime pay,
- bonus,
- gratuity,
- commission,
- fees,
- emoluments,
- pension received,

- retirement allowances,
- annuities received by an employer,
- voluntary awards on retirement,
- lump sums from pension, provident and retirement annuity funds,
- amounts paid in commutation of employment contracts,
- any taxable fringe benefits, and
- directors' remuneration and fees.

The regulation referred to in section 11(w)(dd)(C) is Regulation R2408.⁶ Its provisions can be summarised as follows:

- Policies, which conform to the regulations, can only be endowment policies (not pure endowments) which have a fixed maturity date or whole life. The policy must provide for the payment, during any policy year in which it is in force, of a death benefit. A policy year is a period of twelve months commencing on the commencement date of the policy or a subsequent period of twelve months from the anniversary of that date.
- A minimum amount of life cover is required and must be calculated as follows:

For an endowment policy it is the number of years to maturity (maximum twenty) multiplied by 80% of the lowest premium payable in the relevant year or any

⁶ GN 2408 *Government Gazette* 8442 of 12 November 1982.

preceding year (excluding premiums for disability, accidental death, occupational or health loading).

For a whole life policy it is the number of years expectation of life (maximum twenty) multiplied by 80% of the lowest premium payable in the relevant year or any preceding year (excluding premiums for disability, accidental death, occupational or health loading).

- The policy must apply to one life assured only and no other life assured may be substituted therefor. A group life policy can therefore not be used as a tax-deductible policy for a deferred compensation scheme.
- Premiums must be payable at regular intervals (yearly, six monthly, quarterly, monthly or weekly) until 'maturity date' (maximum of twenty years) in the case of endowment policies or for expectation of life (maximum of twenty years) in the case of whole life policies or until the earlier death or disablement of the life insured.

'Maturity date' has the following meaning:⁷

- i. Where the policy provides for the payment of a benefit upon a date specified in the policy or upon the earlier death of the life insured, the specified date is the maturity date, or where the policy provides for the payment of benefits on more than one date, the latest date on which such benefit will become payable will be the maturity date.

⁷D Meyerowitz, *Meyerowitz on Income Tax*, 1997 - 1998 at 12-60.

‘ii. Where the policy does not fall under (i), the maturity date is the date falling at the end of the period of life expectancy of the person whose life is insured under the policy, as determined immediately before the commencement date of the policy in accordance with a mortality table contemplated in paragraph 4(b) of the Second Schedule to the Insurance Act 27 of 1943.’

- Premiums may only be increased at regular yearly (or longer) intervals by a fixed or ascertainable amount not exceeding 15% a year.

The Regulation refers to the Sixth Schedule which allowed a maximum annual increase of premiums on policies of 15%. This has since been repealed and the Insurance Act now allows an annual increase of 20% without there being any restrictions placed on the policy. The Regulation has not, however, been amended and therefore in order for a policy to conform to the Regulation the annual increase of premiums may not be more than 15%. The *Momentum Life Tax and Investments Easiguide* in its commentary on this point states the following:⁸

‘Although the Sixth Schedule was abolished and replaced by the new policy regime permitting increases of 20% p.a., the reference in the State President’s policy regulations to Para 11, Sixth Schedule (requiring premium increases to be limited to 15% p.a.) still remains, and must according to a Revenue spokesman still be adhered to as if the Sixth Schedule was still in existence. Revenue appear to rely on the case of *Solicitor-General v Malgas*, 1918 AD 489 which

⁸MA Kourie and J Oosthuizen, *Momentum Life Tax and Investments Easiguide*, Butterworths 1996 at 380.

held that “where the provisions of one statute or incorporated by reference in another, the repeal of the earlier measure does not operate to repeal the incorporated provisions ... because the provisions referred to become part of the second statute. Thus the repeal of one does not affect the operation of the other”.’

- Policies may be ‘lapsed’ on non-payment of premiums, or they may be made ‘paid-up’ in which case the ‘paid-up’ benefits must be paid not later than the date specified under the policy before it was made ‘paid-up’.
- The requirements must be embodied in the policy contract and the policy cannot be amended so that it no longer complies with the requirements.

There are certain additional conditions that must be met in terms of section 11(w) before a deduction will be allowed. These conditions are set out in section 11(w) and can be summarised as follows:

- The policy must be the property of the employer.
- The policy must be on the life of an employee or a director.
- Only the employer may be entitled to receive any benefit under the policy. (No beneficiary nomination is allowed.)

- The premium must actually have been paid.
- No loans or advances against the policy may be outstanding, unless the loan or advance is included in the taxpayer's gross income in terms of paragraph (m). Two situations must be distinguished:

A loan effected prior to 1 June 1982.

The loan, whether from the assurer or anybody else, would not be included in gross income, but the employer could not deduct any premiums while the loan remained outstanding.

A loan effected after 1 June 1982.

In this situation, it is necessary to ascertain whether the loan was obtained from the assurer or from somebody else. If the loan was obtained from the assurer, the loan amount would be included in gross income in the year it is granted, but the premiums would still be deductible. If the loan was obtained from anybody else, on the strength of the policy, the loan amount will not be included in gross income, but the premiums cannot be deducted while the loan is outstanding.

Meyerowitz in *Meyerowitz on Income Tax* looks at this point and comments as follows:⁹

‘The words “or on the strength of the policy” widen the scope of the prohibition beyond a pledge or cession which affords a legal security. In the absence of such legal security it becomes a question of fact in any particular case whether or not a loan or advance has been made on the strength of the policy. In the widest sense, it can be said that whenever the lender is aware that the taxpayer has a policy among his assets and he lends on the strength of the taxpayer’s assets generally, then *pro tanto* the loan or advance is made on the strength of the policy e.g. where the lender takes a notarial general bond. It is considered that the construction of the words is too wide and that a loan or advance is only made on the strength of the policy when the fact that the taxpayer owns the policy is either the specific or the dominant factor which induces the lender. If the lender would have made the loan or advance whether or not the taxpayer owned the policy, then it cannot be said that the loan or advance was on the strength of the policy.’

If the loan or advance was obtained in order to obtain funds required by the taxpayer for the purposes of his trade in consequence of the employee’s or director’s

- ill-health,
- infirmity,
- incapacity,
- retirement, or

⁹ D Meyerowitz, *Meyerowitz on Income Tax*, 1997 ♦ 1998 at 12-57.

- cessation of services

then the condition regarding the loan will be satisfied and the premiums will be deductible.

If a policy satisfies the provisions of the regulation as set out above, then it is said to be a 'conforming' policy and the premiums will be deductible in the employer's hands. If one or more of the provisions are not satisfied then the policy will be 'non-conforming' and the premiums will not be deductible.

'Conforming' policies

If the policy taken out by the employer is a 'conforming' policy then the premiums payable by the company are deductible from the employer's income in terms of section 11(w) and are not added to the employee's remuneration. In this way the employer saves the tax in the same way as if a salary increase had been given to the employee.

At maturity, the proceeds of the policy will be taxed as gross income in the hands of the employer in terms of paragraph (m) of the definition of 'gross income', but on payment to the employee in pursuance of the service agreement or an established practice, the proceeds will be deductible from the employer's income in terms of section 11(a). The amount included in the gross income of the employer on receipt of the policy proceeds

will be offset by the deduction allowed on payment of an amount equal to the policy proceeds to the employee.

'Non-conforming' policies

It could also be of advantage to the employer or employee for the employer to effect a pure endowment policy on the life of the employee for deferred compensation purposes, as the policy would have no limitation on the term of the contract or the premiums payable. Furthermore, although premiums on the contract will not be deductible from the employer's gross income the proceeds will be free of tax in the employer's hands.

Instead of saving tax every year the employer saves tax at the end of the policy term when it hands over the gratuity to the employee in terms of the service agreement. The total lump sum is deductible from the income of the employer in pursuance of its legal obligation to make the payment.

It is the practice of the Commissioner to permit the following¹⁰:

- The deduction of premiums paid by the employer, while owner of the policy from the time the life insured becomes a director or employee, irrespective of the fact the he was not a director at the time the policy was taken out and irrespective of whether the employer took out the policy or acquired it by cession.

- The deduction of premiums paid by the employer, while owner of the policy after the life insured ceases to be director or employee.
- The deduction against the taxable proceeds of premiums paid by the employer, while owner of the policy, prior to the life insured becoming a director or employee.
- The deduction against the taxable proceeds of any consideration paid by the employer for cession of a policy, in respect of which, at the time of cession or at any time thereafter, the life insured was or became a director or employee, unless the facts indicate that the consideration involved some form of tax avoidance.

¹⁰ D Meyerowitz, *Meyerowitz on Income Tax*, 1997 ♦ 1998, The Taxpayer at 12-59.

The tax position at retirement, disability or retrenchment

Paragraph (*m*) of the definition of 'gross income' includes in the gross income of the employer or company the following:

'Any amount received or accrued under or upon the surrender or disposal of, or by way of any loan or advance granted on or after 1 July 1982 by the insurer concerned under or upon the security of, any policy of insurance upon the life of any person, who at any time while the policy was in force, was an employee of the taxpayer or, where the taxpayer is a company, was a director or employee of that company, if any premium paid in respect of such policy is or was deductible from the taxpayer's income, whether in the current or any previous year of assessment, under the provisions of section 11.'

It is therefore important to determine whether the premiums were deductible under the provisions of section 11.

The Act uses the word 'deductible' as opposed to 'deducted' which must be interpreted to mean 'entitled to be deducted' and not 'actually deducted'.

This will mean that the proceeds will still have to be included in paragraph (*m*) of the definition of 'gross income' if the premiums satisfy the provisions of section 11(*w*) and were therefore deductible and the employer failed to deduct them.

An employer who requires the proceeds of the policy to not be taxable must therefore ensure that the premiums fail to satisfy the requirements which will make them

deductible. This means that with a regulation or 'conforming' policy that one of more of the requirements must not be adhered with.

Once it has been determined that the premiums paid on the policy were deductible, then the proceeds will satisfy paragraph (*m*) of the definition of 'gross income' and will therefore form part of the employer's gross income and be taxable. The employer is permitted to deduct certain amounts from the proceeds of the policy. These are as follows:

- The purchase consideration paid by the employer for cession of the policy into its own name.
- The gross amount of loans already taxed in terms of paragraph (*m*).
- The total of premiums previously disallowed.

Section 11(w)(iii) reads as follows:

- '(iii) if, during the year of assessment, any sum (being a lump sum included in the taxpayer's gross income under paragraph (*m*) of the definition of "gross income" in section 1) has been received by or has accrued to the taxpayer under or upon the surrender or disposal of the said policy, an amount (not exceeding such lump sum) equal to so much of the premium paid by the taxpayer under the said policy as has not qualified for deduction

(whether by way of an allowance under this paragraph or otherwise) from the taxpayer's income in the said year of assessment under this Act and any previous Income Tax Act.'

In terms of section 11(w)(iii) any premiums, which did not qualify for deduction for any reason, including premiums paid before the enactment of section 11(w) will be deductible in the year in which there is a lump sum which is taxable in the hands of the taxpayer. This deduction is limited to the amount of the taxable lump sum and it is not permitted at all if, instead of a lump sum, annuities or income payments are payable under the policy. The allowances made in respect of premiums cannot exceed in total the amount of the actual premiums paid by any person other than the taxpayer, nor does it apply to any consideration which the taxpayer may have paid or given to any person for cession of the policy.

If the premiums were not deductible then paragraph (m) will not apply and the proceeds will not form part of the gross income of the employer.

Payment of Proceeds to the Employee

Lump Sums

When the employer then pays the lump sum amount over to the employee, he may be allowed a tax deduction in terms of section 11(a) read with section 23(g).

Section 11(a) is the positive leg of the test regarding deductions and reads as follows:

‘For the purpose of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall be allowed as deductions from the income of such person so derived ... expenditure and losses actually incurred in the Republic in the production of the income, provided such expenditure and losses are not of a capital nature.’

Section 23(g), the negative leg of the test, goes on to read as follows:

‘No deductions shall in any case be made in respect of the following matters, namely ... any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade.’

The employer is required to show that the payment to the employee is in the production of the income and laid out or expended for the purposes of trade. He will be required to justify the deduction and may do so on one of the following grounds:

The payment was made in terms of a contractual obligation assumed by the employer while the employee was still in employment.

This could be shown by way of the service agreement and a board resolution ‘laying down that the intention of the employer is to ‘retain the services of certain valued employee’ and to ‘promote settled conditions of employment by entering into service contracts with such employees in terms of which such employees will be encouraged to remain in the service of the employer until the attainment of their normal retirement dates at which time they will become entitled to lump-sum payments as determined under each service contract.’

In the case of *PE Electric Tramway Company. Ltd. v CIR*¹¹ the court examined the closeness of the connection between expenditure incurred by the taxpayer and the production of income as a result of such expenditure.

The court held as follows:¹²

‘What attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.’

¹¹ 1936 CPD 241, 8 SATC 13.

¹² Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241, 8 SATC 13 at 17.

In terms of this judgment, if the employer can show that the lump-sum payment was made to ensure the more efficient performance of employees at the employer's business then the deduction will be allowed.

The payment was made pursuant to an established policy on the part of the employer and that the employer's purpose in so doing was to foster a good spirit among his employees and to ensure their loyalty, and thereby continue to produce income for the employer.

There are two court decisions on point as to whether the amount will be allowed as a deduction in terms of section 11(a) read with section 23(g).

In the first, *WF Johnstone & Co v CIR*¹³ the employer had set up a superannuation and provident fund for the benefit of its employees. Certain employees were too old to join the fund. In the year of assessment four employees retired from the company. One was given a monthly pension and the other three were awarded gratuities. The resolution of the Board of Directors in terms of which the gratuities were paid recorded that the payments were made 'in recognition of services rendered to the employer'. The Commissioner disallowed the deduction of these amounts and the employer appealed to the Special Court.

¹³ 1951 (2) SA 283 (A), 1951 AD, 17 SATC 235.

The Special Court dismissed the appeal stating as follows:¹⁴

‘The Court is not satisfied that beyond the idea, which may be considered to be generally prevalent, that it is good business for an employer to treat his employees with liberality in such cases as occurred here, that the directors were actuated by any other motive than that of providing for ex-employees who were retiring for reasons of old age and who in the particular circumstances were ineligible for pensions. It does not appear that such a policy had been pursued in the past. These gratuities were the only cases.... The court is therefore of the opinion that these were extraordinary payments and that the real reason that influenced the directors in making them was in recognition of past services rendered to the company. As such they did not form part of the ordinary operations undertaken by the company for the purpose of conducting its business; nor were they payments made for the purpose of earning income. Lastly they were not payments made wholly and exclusively for the purpose of the appellant’s trade.’

The employer appealed to the Appellate Division of the High Court. The Appellate Division refused the deduction of the lump sum on the following grounds:¹⁵

‘This Court must, therefore, accept it that the payments in question were made in recognition of past services rendered to the company. That being the position they do not constitute “expenditure and losses actually incurred in the Union in the production of income” within the meaning of section 11(2)(a) of the Income Tax Act nor were they “wholly and exclusively paid out or expended for the purposes of trade” within the meaning of section 12(g) of the Act. The fact that the payments made constituted gross income in the hands of the recipients in terms of para (b) of the definition of “gross income” in section 7 of the Act is irrelevant to the question whether they fall within sections 11(2)(a) or 12(g) of the Act.’

¹⁴ 1951 (2) SA 283 (A), 1951 AD, 17 SATC 235 at 243.

¹⁵ 1951 (2) SA 283 (A), 1951 AD, 17 SATC 235 at 245.

In the second, *Provider v COT*¹⁶, the employer put into place two schemes for the benefit of its employees – a life assurance scheme and a service bonus scheme. In terms of these schemes, the employer undertook to pay a bonus upon retirement to any employee who had been in the employer's service for a certain period, and also a benefit to the dependants of employees who died in the employer's service, the amount of the bonus or benefit depending on the length of service of the employee.

The Commissioner allowed the bonuses but disallowed the payments to dependants of deceased employees. The taxpayer, dissatisfied with the decision of the Commissioner took the decision on appeal.

The court held as follows:¹⁷

‘Now the motives with which the schemes were introduced may have been somewhat mixed but their main purpose was clear. The company is a commercial undertaking and not a philanthropic institution, and the whole tenor of the schemes makes it clear that they are designed to secure a contented staff, giving long and continuous service with the benefits to production which must follow such conditions. They are closely analogous to the annual bonuses and other deferred emoluments which are clearly allowable for income tax purposes.’

¹⁶ 1950 SR 161, 17 SATC 40.

¹⁷ 1950 SR 161, 17 SATC 40 at 42.

The court in looking at the payments to dependants held as follows:¹⁸

‘It may well be simply an act of gratitude for past services.... But the position is distinguishable when a clearly defined scheme of specified benefits is offered in advance. Where each employee entering the service of a concern knows that, should he die, his dependants will, in the ordinary course, receive certain benefits, it seems to me that the offer of these benefits should properly be regarded as an inducement to him to enter such service. Where these benefits increase with the length of his service, there is further incentive to give long and continuous service. It seems to me that such a scheme must, in the case of a commercial concern, and in the absence of any indication to the contrary, be regarded as designed to promote settled conditions of employment and through these the production of income.’

It is clear from these two judgments that the reason for the employer paying the lump sum to the employee is vitally important. If the Commissioner believes it to be in respect of past services then the deduction will not be allowed unless the employer can prove otherwise.

Once the employer has shown that a service agreement has been entered into or that the payment is in terms of an established practice then the Commissioner and the courts will look at the amount of the award in relation to the following:

- The size and scope of the business.

¹⁸ 1950 SR 161, 17 SATC 40 at page 43.

- The age of the employee at the time of signing the service contract in which the deferred compensation award is specified. This will show the length of service that the employee still has with the employer.
- The nature of the service of the employee. The court will look at the position which the employee holds and determine whether it is of sufficient importance to the employer to warrant offering a deferred compensation scheme to persuade him to remain in the employer's employment.

The Commissioner may therefore decide not to allow the full maturity value of a policy when dealing with the deduction which an employer is allowed in terms of section 11(a) read with section 23(g).

Annuity Payments

The employer may decide to pay the employee by way of annuity rather than by awarding a lump sum.

This may be done by the employer retaining and investing the lump sum to provide regular payments to the employee. The employer will include the full lump sum in gross income in terms of paragraph (m) of the definition of 'gross income' and will only be able to deduct the periodic payments in terms of section 11(m) to the ex-employee as and when they are paid.

The employer may effect an endowment policy on the life of the employee and make provision for the proceeds to be paid by way of annuity payment. Using this method, the employer will receive the periodic payments from the life office and will add those amounts to its gross income as and when they are received. It will then be deducted when it is paid over to the ex-employee periodically in terms of section 11(*m*).

Any amount, which is paid by way of an annuity by an employer to a former employee who retired due to old age, ill health or infirmity, will be deductible in the hands of the employer under section 11(*m*).

Tax position on cession of the policy to the employee or new employer

On leaving an employer, an employee may decide that instead of taking a lump-sum cash amount, he would rather take over the policy, continue to pay the premiums and thereby have an increased maturity value when the policy matures.

Alternatively, he may be joining a new employer who has offered a deferred compensation scheme and rather than start with a new policy, allow the existing policy to form the basis of the new agreement.

The employee may then request the ex-employer to cede the policy across to him or to cede it to his new employer so that the new employer can take over ownership of the

policy. Cession of an 'employer owned policy' will have tax implications for both the cedent and the cessionary in most cases.

Cession to Employee

When an employer cedes a policy to an employee, a value for the policy will be added to the gross income of the employee in the year of assessment in which he takes cession of the policy. This is because the definition of 'gross income' includes 'cash or otherwise'.

The value of a policy when it is ceded in a normal situation is usually the surrender value of the policy at the time that the cession is effected. This is, however, not the case when dealing with policies ceded by an employer to a director or employee.

The Commissioner and the Life Offices Association have reached an agreement on the practice to be adopted for determining the taxable value to be included in paragraph (d) or (m) of any policy ceded by an employer to an employee or director, or former employee or director, or wife or dependants of the employee or director whose life is insured under the policy.

The value of the insurance policy will be determined by calculating the present value of the expected future benefits and then subtracting the present value of all future premiums.

The rate used in calculating the present value of the benefits and premiums is 11%.

Certain assumptions must be made in relation to the rate of bonuses,

- the payment of premiums,
- the value of investment portfolios, and
- the life expectancy of the employee or former employee.

This ‘cession value’ will, in most cases, exceed the ‘surrender value’ of the policy and it has been specifically provided in the Practice Note¹⁹ of the Commissioner that the ‘cession value’ can never be less than the ‘surrender value’.

The ‘practice note’ as adopted by the Commissioner and the Life Offices’ Association reads as follows regarding the assumptions:²⁰

‘A **EXPECTED FUTURE BENEFITS**

- ‘(i) Where surplus distribution takes place by way of reversionary bonuses (and terminal bonuses where appropriate) are determined exclusively at the discretion of the insurer, the Estimated Future Benefits are to be calculated by assuming that the insurer’s bonus rates (of whatever type) current at the time of the cession and applicable to that type of policy will be maintained indefinitely
- ‘(ii) Where the policy participates in surpluses on a predetermined basis in accordance with the performance of some portfolio of investments or where

¹⁹ ‘The Cession Value of Employer-Owned Life Policies’, *Insurance and Tax*, November 1986 at 3.

²⁰ ‘The Cession Value of Employer-Owned Life Policies’, *Insurance and Tax*, November 1986, at 3.

bonuses, which might or might not vest, are determined by the insurer so as to give more direct participation in investment performance (particularly capital appreciation) than reversionary bonuses are declared by way of additions to a premium accumulation account, the Expected Future Benefits are to be calculated by assuming that the existing equity in the policy or the premium accumulation account (as the case may be) as at the date of cession and subsequent additions thereto will grow indefinitely at 11% per annum compound interest.

‘Any further bonus flowing for example from the performance to date but not included in the existing equity in the policy or the premium accumulation account (as the case may be) shall be included in the Expected Future Benefits, by assuming that such bonus will grow at a rate of 11% per annum compound.

‘B FUTURE PREMIUMS

- ‘(I) For policies, the Estimated Future Benefits which are calculated in accordance with para A(i) the Future Premiums are to be taken as the sum of
- (a) the Pure Net Premium that would be required to secure the Expected Future Benefits and
 - (b) an allowance for initial expenses equal to 110% of the sum of first and second year commission payable under the policy (on the maximum scale applicable to brokers as laid down by the Regulations under the Insurance Act) spread over the premium paying term of the policy.

Both (a) and (b) are to be computed according to the Ultimate Mortality of S.A. 56 – 62 at 11% per annum. In the case of pure endowments (whether with or without return of premiums) mortality may be ignored throughout.

- ‘(ii) For policies, the Estimated Future Benefits which are calculated in accordance with para A(ii) the Future Premiums are as stipulated in the policy.

‘C **PRESENT VALUE**

‘The Present Value is calculated according to the Ultimate Mortality of S.A. 56 – 62 at 11% per annum. In the case of pure endowments (whether with or without return of premiums) mortality may be ignored throughout.

- ‘D (i) In the case of a policy which is paid-up at date of cession, the value of the paid-up policy *and* the value of the policy if it were to be reinstated at date of cession shall be determined. The insurer concerned shall notify the Secretary for Inland Revenue (now Commissioner) should such policy subsequently be reinstated.

- ‘(ii) In the case of a policy, which is not paid-up at date of cession, both Estimated Future Benefits and Future Premiums are to be valued on the assumption that all premiums due after the date of cession will be paid in accordance with the relevant contingencies.

- ‘(iii) In either case any loan or advance existing at the date of cession (or which would not have existed but for a reduction in the benefits) may NOT be deducted from the present value of gross benefits subject to debt.

- ‘E Where the terms of the policy are indeterminate in the sense that certain options have been included (relating for example to the magnitude of the policy or the date of maturity) it should be assumed that such option(s) will be exercised as will yield the highest assessment.

‘F Notwithstanding the above the assessed value shall in no event be lower than the insurer’s customary surrender value that would have applied had the policy in question not been issued with a deferred compensation agreement.

‘G The correctness of the value of the policy as determined above shall be certified by the insurer’s valuator.’

This would appear to be an arbitrary method of valuation and not in line with the decisions of the courts when it comes to determining the value of an asset other than cash.

In terms of the definition of ‘gross income’, gross income is the total amount received by or accrued to the taxpayer, whether in cash or otherwise. It includes the value of every form of property earned by the taxpayer which has a money value.

In the case of *Lace Proprietary Mines Ltd. v CIR*²¹ the Appellate Division of the High Court had to determine what value should be placed upon an asset other than cash received. The court held that the value should:²²

‘be ascertained by enquiring what price could have been obtained for them, by adopting some reasonable method of sale on that date’.

The court went on to say the following:²³

‘What has to be looked for is a person who is willing to buy wholesale at a price under the retail price of the Stock Exchange quotation.’

(This case was dealing with the valuation of shares.)

The court therefore held that the open market value must be used in valuing assets other than cash. This rule of valuation, as laid down by the Appellate Division of the High Court, must take precedence over a valuation formula adopted by the Commissioner in practice as a result of an agreement with the Life Offices Association.

²¹ 1938 AD 267, 9 SATC 349.

²² 1938 AD 267, 9 SATC 349 at 362.

²³ 1938 AD 267, 9 SATC 349 at 362.

Cession to New Employer

The ex-employer and new employer involved in the cession will come to some agreement as to whether the policy will be ceded for a cash consideration or not. This decision will have tax implications for the parties concerned.

For a cash consideration

If the ex-employer elects to cede the policy to the new employer for a cash consideration, then the consideration which it receives will be included in the ex-employer's gross income in terms of paragraph (*m*) of the definition of 'gross income' in the Act.

The payment of the 'purchase price' made by the new employer to the ex-employer will not be deductible in terms of section 11(*w*) of the Act even though the proceeds may be taxable in the hands of the new employer in terms of paragraph (*m*).

The consideration paid can also not be deducted under section 11(*a*). Even though the consideration has been paid 'in the production of income', the policy is a fixed capital asset and cannot be converted to a revenue asset merely because the proceeds thereof are regarded as income in terms of paragraph (*m*). The asset remains a capital asset and the consideration, being expenditure of a capital nature cannot be deducted in terms of section 11(*a*).

The Commissioner will, in practice, by way of concession allow the consideration paid for the cession as a deduction from the proceeds received on maturity or disposal of the policy.

For no cash consideration

It is unlikely that a policy with a value attached to it will be ceded from one employer to another for no consideration, merely because the employee to which the policy relates has left the service of the first employer to take up employment with the second one.

This may, however, occur where the first employer is obliged to cede over the policy in terms of a legally enforceable obligation (for example, a clause in the service agreement) or if the employee indirectly funded the premiums on the policy either through a salary sacrifice or by foregoing an increase in his remuneration.

If the ex-employer does in fact cede the policy across to the new employer for no consideration then he is in effect donating an asset to the new employer and there will be a donations tax implication for the ex-employer.

Part V of the Act deals with donations tax. Section 55 of the Act sets out the definitions that apply to the provisions relating to donations tax.

Section 55 contains the following definition, amongst others:

“donation” means any gratuitous disposal of property including any gratuitous waiver or renunciation of a right.

“property” means any right in or to property movable or immovable, corporeal or incorporeal, wheresoever situated.’

An insurance policy would satisfy the definition of ‘property’ and the cession for no value would satisfy the definition of ‘donation’ as set out in section 55 and therefore if the ex-employer elects to cede the policy to the new employer for no consideration, the ex-employer will be liable for donations tax in terms of section 55 of the Act.

Donations tax is levied at a flat rate of 25% on the value of the donation and is payable within three months of the donation by the person donating the asset. If, however, the donor fails to pay the tax to the Commissioner within the time limit prescribed, the Commissioner is permitted in terms of section 60(5) to collect the tax from either the donor or the donee.

It is therefore necessary for the Commissioner to determine what value should be placed on the policy in order to determine the amount of donations tax which must be levied.

Section 62 of the Act sets out how the value of the property that has been donated should be determined.

Section 62(1)(d) reads as follows:

‘For the purposes of donations tax the value of any property shall be deemed to be ... in the case of any other property, the fair market value of such property as at the date upon which the donation takes effect: Provided that in any case in which, as a result of conditions which in the opinion of the Commissioner were imposed by or at the instance of the donor, the value of any property is reduced in consequence of the donation, the value of such property shall be determined as though the conditions in terms of which the value of the said property is reduced in consequence of the donation, had not been imposed.’

The Commissioner would therefore have to determine the fair market value of the policy. He will look at the ‘surrender value’ of the policy, the remaining term of the policy, the advantages of holding that policy to a policyholder and what the man in the street would pay for that particular policy.

Tax position on death of the employee prior to retirement

As the employee is the life assured on the policy, on his death the insurer will pay out a death claim to the owner of the policy when notified of the death of the life assured. The owner of the policy is the employer and it is therefore the employer which will receive the proceeds of the policy. These proceeds will be included in the employer’s gross income in terms of paragraph (*m*) of the definition of ‘gross income’.

If the proceeds are paid to the employee's estate or the employee's dependants in terms of the service agreement, the amount paid by the employer will be deductible in terms of section 11(a) read with section 23(g) of the Act.

If the payment to the dependants of the deceased employee is in terms of a service agreement then the employer can show that it was an expense incurred for the purposes of trade and provided that the amount is reasonable, then the Commissioner will allow the deduction. If, however, the proceeds are paid by the employer on a discretionary basis, in other words, not in terms of the contract, the amount paid will not be deductible from the employer's income.

An employer may decide, instead of paying a lump sum to the dependants, to use the proceeds to purchase a voluntary annuity on the life of a dependant to provide the dependant with a monthly pension. The proceeds used to purchase the annuity will be regarded as being of a capital nature and will therefore not be deductible in the employer's hands. The voluntary annuity will also have been bought in the name of the employer and will therefore be added to the employer's gross income in terms of paragraph (a) of the definition of 'gross income'. Section 11(m)(iii) allows a deduction for the following:

'Any amount paid by way of annuity during the year of assessment by any taxpayer ... to any person who is dependent for his maintenance upon a former employee or a former partner in an

undertaking carried on by the taxpayer or (where such former employee or former partner is deceased) was so dependent immediately prior to his death.’

Section 11(*m*), however, has a proviso that reads as follows:

‘Provided that the deduction under subparagraph (iii) shall not exceed in respect of the persons so dependent on any one retired or deceased employee or former partner, the sum of R2 500.’

The portion of the annuity that exceeds R2 500 will be taxable in the hands of the employer, as it cannot be deducted under section 11(*a*). Section 23B of the Act prohibits double deductions and section 23B(3) specifically prohibits deductions under section 11(*a*) and (*b*) where a deduction may be granted under another provision in respect of the same expenditure.

Chapter 6

Tax Implications for an Employee

At inception of the scheme

The premiums paid by the employer in respect of the deferred compensation scheme will not constitute a taxable benefit in the hands of the employee, provided the payment of the premium does not fall within the provisions of section 7(1) which provides that any income is deemed to have accrued to a person where such income is accumulated or capitalised in his name or on his behalf.

To avoid having the premiums taxed in the employee's hands as deemed income, the service agreement must not confer a right to the policy or its proceeds to an employee on resignation, but only in the event of death, disability, 'normal' retirement and retrenchment.

Tax position at retirement, disability or retrenchment

Section 1 of the Act defines 'gross income' as follows:

“‘gross income’ in relation to any year or period of assessment, means, in the case of any person, the total amount, in cash or otherwise, received by or accrued to or in favour of such person during such period of assessment from a source within or deemed to be within the Republic, excluding

receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder...’

Paragraph (d) then provides as follows:

‘Any amount, including any voluntary award, received or accrued in respect of the relinquishment, termination, loss, repudiation, cancellation or variation of any office or employment or of any appointment (or right or claim to be appointed) to any office or employment: Provided that –

- ‘(i) the provisions of this paragraph shall not apply to any lump sum award from any pension fund, provident fund or retirement annuity fund;
- ‘(ii) any such amount which becomes payable in consequence of or following upon the death of any person shall be deemed to be an amount which accrued to such person immediately prior to his death.’

The amount received by an employee at retirement will be included in his gross income in terms of paragraph (d) of the definition of ‘gross income’ and, therefore, will be subject to income tax.

In certain circumstances the employee will be entitled to a tax exemption against this lump-sum award which he receives.

Section 10(1)(x) reads as follows:

‘There shall be exempt from tax ...

‘So much of any amount (being a lump sum) referred to in para (d) of the definition of ‘gross income’ in section 1 of in section 7A(4A) or (5) as does not exceed R30 000 less any other amounts which have been excluded from the taxpayer’s income by virtue of the exemption conferred by this paragraph, whether in the current or any previous year of assessment: Provided that the exemption under this paragraph shall not apply in respect of any amount received by or accrued to any person upon or because of the termination or because of the impending termination of the services required to be rendered by him as the holder of any office or employment or in respect of the relinquishment, termination, loss, repudiation, cancellation or variation of his office or employment or in respect of his appointment (or right to be appointed) to any office or employment, unless –

- ‘(i) such person has attained the age of fifty-five years in the case of a male or fifty years in the case of a female; or
- ‘(ii) the termination or impending termination of such person’s services or the relinquishment, termination, loss, repudiation, cancellation or variation of his office or employment or of his appointment (or right or claim to appointed) to any office or employment is due to superannuation, ill-health or other infirmity; or
- ‘(iii) ...
- ‘(iv) the termination or impending termination of such person’s services is due to his employer having ceased to carry on or intending to cease carrying on the trade in respect of which such person was employed or to such person having become redundant in consequence of

his employer having effected a general reduction in personnel or a reduction in personnel of a particular class and, where such person's employer is a company, such person was not at any time a director of such company and did not at any time hold more than five per cent of the issued share capital or members' interest in such company;

'Provided further that, notwithstanding the provisions of section 37D, any such amount which was received by or accrued to a married woman and which was in whole or in part excluded from her husband's taxable income under the provisions of this paragraph, shall for the purposes of determining the exemption under this paragraph in respect of any such amount subsequently received by or accrued to either spouse be deemed to be an amount which was received or accrued to the husband.'

Section 10(1)(x) of the Act allows a maximum exemption of R30 000 per taxpayer in aggregate in respect of all lump-sum awards on relinquishment, loss, repudiation, variation or appointment to any office or employment or in respect of any bonus, gratuity or compensation upon or because of impending termination of services in the next five years.

It is important to note that sub-paragraph (i) of section 10(1)(x) does not apply if a taxpayer has not attained the age of fifty five years in the case of a male or fifty years in the case of a female on the date of payment or accrual of the lump sum even though he or she may reach that age on or before the end of the year of assessment.

SARS –Income Tax Practice Manual contains the following statement in this regard:²⁴

‘The view is held that a “lump sum” as envisaged by section 10(1)(x) includes the value of an asset and the provisions of the section are, therefore, also applicable where an asset is received by a taxpayer under the circumstances referred to in the section. The provisions of section 7A(4A) of the Income Tax Act are also applicable to the taxable value of such an asset.’

The employer may give the retiring employee the option of taking the consideration in the form of monthly payments rather than taking the lump sum.

These monthly payments will constitute an annuity and will fall into the gross income of the employee in terms of paragraph (a) of the definition of ‘gross income’.

Paragraph (a) reads as follows:

‘Any amount received or accrued by way of annuity, including any amount contemplated in the definition of ‘annuity amount’ in section 10A(1).’

The employee will have to consider this option carefully because should the employer decide to pay the employee by way of an annuity, then the section 10(1)(x) exemption will not apply. Section 10(1)(x) only applies to lump-sum awards and does not cover payments made from time to time.

²⁴ South African Revenue Services Income Tax Practice Manual, Issue 1, page A-399

There is one exception to this rule as is pointed out in the *SARS – Income Tax Practice Manual* which states the following:²⁵

‘Only two such payments are to be taken into account for purposes of the exemption, namely one payment during the five years preceding the termination of the employee’s services, and one payment coinciding with such termination. A further requirement is that the first of such payments should be in respect of all leave standing to the employee’s credit at that point in time. The other requirements of section 10(1)(x) must, of course, also be complied with.’

The employee will also qualify for the average rate concession set out in section 7A(4A) of the Act. Section 7A(4A) provides for circumstances where an amount is received or accrues by way of a bonus, gratuity or compensation because of the impending termination of an employee’s services within five years from the date of the actual receipt or accrual of the amount.

²⁵ *SARS - Income Tax Practice Manual*, Issue 1 at A-394

Section 7A(4A) reads as follows:

‘Where the taxable income of any taxpayer for any year of assessment includes any amount (other than an amount contemplated in paragraph (e) of the definition of ‘gross income’ in section 1) received by or accrued to him as an employee or the holder of any office by way of bonus, gratuity or compensation upon or because of the termination of his services or because of the impending termination of his services within five years (or such longer period as the Commissioner may approve) from the date of actual receipt or accrual of such amount, and –

‘(a) the taxpayer has attained the age of fifty-five years in the case of a male or fifty years in the case of a female; or

‘(b) the termination or impending termination of the taxpayer’s services is due to superannuation, ill-health or other infirmity; or

‘(c) ...

‘(d) the Commissioner is satisfied that -

‘(i) the termination or impending termination of the taxpayer’s services is due to his employer having ceased to carry on or intending to cease carrying on the trade in respect of which the taxpayer was employed or to the taxpayer having become redundant in consequence of his employer having effected a general reduction in personnel or a reduction in personnel of a particular class; and

‘(ii) the circumstances of the case warrant this concession,

‘the normal tax payable by the taxpayer in respect of such year shall, subject to the provisions of section 5, be determined in accordance with the provisions of section 5(10), but nothing herein contained shall be construed as relieving any person from liability for taxation under this Act upon any portion of his taxable income.’

Where the provisions of section 7A(4A) apply to an amount, the amount to which the concessional rate will apply is restricted to the lesser of

- the amount of the gratuity, or
- three times his annual average remuneration over the preceding three years, but excluding from remuneration the sum of any amounts payable in terms of section 7A(4A) which were subject to tax at the concessional rate (average rate) in any previous year of assessment.

Section 5(10) provides that an amount, to which the provisions of section 7A(4A) are applicable, is to be taxed at the higher of the taxpayer’s average rate of tax, either in the year of receipt or accrual of the amount or the preceding year.

Tax position on death of the employee prior to retirement

The proceeds of the policy which are paid to the employee’s estate or dependants in terms of the service agreement are subject to income tax in the hands of the beneficiaries or dependants. Paragraph (d) of the definition of ‘gross income’ provides that any benefit

payable on the death of the employee will be deemed to have accrued to him immediately prior to his death. The employee's estate or dependants may therefore claim the R30 000 lump sum exemption from tax, regardless of the age of the employee at the time of death.

The balance will fall within the scope of section 25 of the Act which reads as follows:

‘(1) Any income received by or accrued to or in favour of any person in his capacity as the executor of the estate of a deceased person, and any amount so received or accrued which would have been income in the hands of the deceased person had it been received by or accrued to or in favour of such deceased person during his lifetime, shall, to the extent to which such income or amount has been derived for the immediate or future benefit of any ascertained heir or legatee of such deceased person, be deemed to be income received by or accrued to such heir or legatee, and shall, to the extent to which such income or amount is not so derived, be deemed to be income of the estate of such deceased person.

‘(2) Any deduction or allowance which may be granted under the provisions of this Act in the determination of the taxable income derived by way of any income or amount referred to in subsection (1) shall, to the extent to which such income or amount is under the provisions of that subsection deemed to be income which has accrued to an heir or legatee or the estate of such deceased person, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by such heir or legatee or such estate as the case may be.’

The balance remaining after the application of section 10(1)(x) will therefore be taxed at the employee's average rate of tax up to a maximum of three times the employee's

average annual salary over the three years preceding the year of assessment in which he dies.

The average annual salary is arrived at by determining the annual salary of the deceased employee in the three years preceding the year in which he died and then adding the three amounts together and dividing the total by three. This amount will exclude the sum of any amounts payable in terms of section 7A(4A) which were subject to tax at the concessional rate (average rate) in any previous year of assessment.

The section 5(10) provision of the higher average rate of tax will not apply where the amount is payable as a result of the death or insolvency of the taxpayer. The amount will be taxed at the taxpayer's average rate in the year of assessment in which he died.

If the employer decides to pay an annuity to the dependants rather than the lump sum then paragraph (a) of the definition of 'gross income' in will apply and the amount will be taxed in the hands of the dependants.

Chapter 7

Estate Duty

The Commissioner in terms of the Estate Duty Act levies estate duty on the estates of deceased persons resident in the Republic at the time of death.

For the purposes of the Act a person's estate consists of:

- all 'property' of the deceased at the date of death; and
- all 'property which is deemed to be property' of the deceased at the date of death.

In terms of section 3(3)(a) of the Estate Duty Act property which is deemed to be property of the deceased includes-

'So much of the amount due and recoverable under any policy of insurance which is a 'domestic policy' as defined in section 1 of the Insurance Act, 1943 (Act No 27 of 1943), upon the life of the deceased as exceeds the aggregate amount of any premiums or consideration proved to the satisfaction of the Commissioner to have been paid by any person who is entitled to the amount due under the policy, together with interest at six percent per annum calculated upon such premiums or consideration from the date of payment to the date of death.'

There is a proviso to section 3(3)(a) stating that the section will not apply in certain circumstances. The second proviso reads as follows:

‘(ii) except where the provisions of paragraph (i) or (iA) of this proviso apply, the Commissioner is satisfied and remains satisfied that such policy was not effected by or at the instance of the deceased, that no premium on such policy was paid or borne by the deceased, that no amount due or recoverable under such policy has been or will be paid into the estate of the deceased and that no such amount has been or will be paid to, or utilised for the benefit of, any relative of the deceased or any person who was wholly or partly dependent for his maintenance upon the deceased or any company which was at any time a family company in relation to the deceased.’

If the employer pays any part of the proceeds of the insurance policy to the estate of the deceased or to the deceased’s dependants in terms of a service agreement then the exemption from estate duty will not apply.

Even if the employer, in terms of the service agreement, agrees to pay ‘an amount equal to the proceeds of the policy’ to the estate of the employee or to his dependants, the Commissioner has stated that he will regard the payment as a payment of the actual proceeds of the policy and therefore dutiable in the estate of the deceased less premiums accumulated at 6% per year.

The proceeds of a policy on the life of an employee received by the employer will be regarded as ‘deemed property’ in terms of section 3(3)(a) and will be dutiable in the deceased estate. The amount on which estate duty will be levied will be the proceeds less the premiums paid by the employer accumulated at 6% per year.

Chapter 8

Conclusion

A deferred compensation scheme makes use of a number of sections of the Income Tax Act to provide a tax efficient investment for both an employer and an employee.

For the employer, the tax advantages allow the employer to attract skilled, efficient employees by offering them additional retirement benefits over and above their benefits from pension or provident fund.

It ensures that the employees are motivated to remain with the same employer for a long period of time which creates a settled workforce and thereby increases productivity for the employer.

For the employee it provides a tax-efficient retirement investment in that the premiums can be funded with pre-tax earnings and although the proceeds which are received on maturity of the policy at retirement are taxed there are concessions available in the form of section 10(1)(x) and section 7A(4A).

DEFERRED COMPENSATION SERVICE AGREEMENT

MADE AND ENTERED INTO by and between

(hereinafter called 'THE EMPLOYER')

AND

(hereinafter called 'THE EMPLOYEE')

WHEREAS the EMPLOYER has established the policy of paying lump sum benefits to selected EMPLOYEES at their normal retirement in order to promote a settled and contented staff and to retain the services of its EMPLOYEES for as long as possible.

IT IS THEREFORE AGREED THAT:

1. The EMPLOYER shall effect an Endowment Policy (hereinafter referred to as "the Policy") on the life of the EMPLOYEE with OLD MUTUAL for an initial premium

of R_____ per annum. The Policy shall be the sole property of and be maintained by the EMPLOYER. The EMPLOYEE shall have no right in and to the POLICY save as is otherwise expressly provided for herein.

2. Upon the EMPLOYEE'S retirement from the service of the EMPLOYER in terms of either the Rules of the EMPLOYER'S Pension Fund, the Service Agreement or settled practice as the case may be, the EMPLOYER shall pay to the EMPLOYEE a sum equal to the proceeds received by the EMPLOYER in respect of the Policy or, at the election of the EMPLOYEE, cede the Policy to the EMPLOYEE and the EMPLOYER shall pay no further premiums under the Policy.
3. If the EMPLOYEE dies prior to retirement whilst in the employ of the EMPLOYER, the EMPLOYER shall pay a sum equal to the proceeds received by the EMPLOYER in respect of the Policy:
 - 3.1 to the nominated beneficiaries in such shares as the EMPLOYEE may have directed in writing from time to time; or failing such direction,
 - 3.2 to the EMPLOYEE'S widow and/or children and/or other dependants and/or the estate of the EMPLOYEE in such shares as the EMPLOYER in its sole discretion shall determine.

4. If the EMPLOYEE'S services are terminated as a result of:

4.1 superannuation, ill-health or other infirmity; or

4.2 total and permanent disablement;

the EMPLOYER shall pay to the EMPLOYEE a sum equal to the greater of any benefit that may be payable in terms of the Policy or the surrender value received by the EMPLOYER in respect of the Policy or, at the election of the EMPLOYEE, cede the Policy to the EMPLOYEE and the EMPLOYER shall pay no further premiums under the policy.

5. In the event of:

5.1 the EMPLOYER being rendered unable to provide employment to the EMPLOYEE as a result of liquidation or deregistration of the EMPLOYER or any other reason whatsoever; or

5.2 the EMPLOYEE being retrenched by the EMPLOYER; or

5.3 the dismissal of the EMPLOYEE within a period of six (6) months as a result of either the EMPLOYER merging with another EMPLOYER or after a change in shareholding of the EMPLOYER;

the EMPLOYER shall pay to the EMPLOYEE a sum equal to the surrender value of the Policy received by the EMPLOYER in respect of the Policy or, at the election of the EMPLOYEE, cede the Policy to the EMPLOYEE and the EMPLOYER shall pay no further premiums under the Policy.

6. Should the EMPLOYER be a COMPANY and should the COMPANY transfer the EMPLOYEE to another COMPANY within an existing or any future group of companies of which it may form part or to a COMPANY which is a Management Company in relation to the COMPANY, it shall cause and ensure that all benefits payable under the scheme shall remain available to and be incorporated in the remuneration package payable by such COMPANY to the EMPLOYEE.
7. In the event of the EMPLOYEE'S service terminating under circumstances other than those mentioned in clauses 2 to 6 hereof, the EMPLOYER may in its sole discretion cede the Policy to the EMPLOYEE and the EMPLOYER shall pay no further premiums under the policy.
8. Notwithstanding anything to the contrary herein contained the EMPLOYER, to the extent that it may suffer a net loss, shall be entitled to set off any Income Tax, Estate

Duty (Capital Transfer Tax) or similar fiscal liability that it may incur in terms hereof, against such payments that may be payable to the EMPLOYEE or his estate.

SIGNED AT THISDAY OF19....

For the EMPLOYER

(Duly authorised thereto)

SIGNED AT THISDAY OF19....

For the EMPLOYEE

(Duly authorised thereto)

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